

Internal Revenue Service

Number: **200808004**

Release Date: 2/22/2008

Index Number: 1362.02-03, 1362.04-00

Department of the Treasury

Washington, DC 20224

Third Party Communication: None

Date of Communication: Not Applicable

Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:PSI:B01

PLR-115975-07

Date: October 22, 2007

Legend

X =

State =

D1 =

D2 =

D3 =

Y1 =

Y2 =

Y3 =

Y4 =

Y5 =

\$a =

\$b =

Dear _____ :

This letter responds to your letter dated March 28, 2007, requesting a ruling that the rental income that X received from certain real property is not passive investment income within the meaning of § 1362(d)(3)(C) of the Internal Revenue Code, or alternatively, seeking a ruling under §1362(f).

Facts

According to the information submitted, X was incorporated under the law of State on D1, and elected to be treated as an S corporation beginning on D2.

X's business consists of leasing commercial property, residential construction and acquiring and developing other real property. In Y1, X sold a business, and in connection with the sale X entered into an agreement to lease to the buyers the real property used by the business. Under the terms of the lease agreement, X is responsible for paying the real property taxes.

In Y5, X became aware that during Y2, Y3, and Y4 it had received income that was potentially passive investment income in excess of 25 percent of its gross receipts. At the close of each of the Y2, Y3, and Y4 tax years, X had \$a of subchapter C earnings and profits.

X represents that it, and its shareholders, have consistently treated X as an S corporation since D2. Further, X represents that they do not believe that the rental income is passive investment income.

Law

Section 1361(a)(1) defines an S corporation, with respect to any taxable year, as a small business corporation for which an S election under § 1362(a) is in effect for such year.

Section 1362(d)(3)(A)(i) provides that an election under § 1362(a) terminates whenever a corporation (I) has accumulated earnings and profits at the close of each of three consecutive tax years, and (II) has gross receipts for each of such tax year more than 25 percent of which are passive investment income.

Except as otherwise provided in subparagraph (C), §1362(d)(3)(C)(i) provides that the term "passive investment income" means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities.

Section 1.1362-2(c)(5)(ii)(B)(1) of the Procedure and Administration Regulations provides that “rents” means amounts received for the use or, for the right to use, property of the corporation.

Section 1.1362-2(c)(5)(ii)(B)(2) provides that “rents” does not include rents derived in the active trade or business of renting property. Rents received by a corporation are derived in the active trade or business of renting property only if the corporation provides significant services or incurs substantial costs in the rental business. Generally, significant services are not rendered and substantial costs are not incurred in connection with net leases. Whether significant services are performed or substantial costs are incurred in a rental business is determined based upon all the facts and circumstances including, but not limited to, the number of persons employed to provide the services and the types and amounts of costs and expenses incurred (excluding depreciation).

Section 1362(f) of the Internal Revenue Code provides, in relevant part, that if: (1) an election under § 1362(a) by any corporation was terminated under paragraph § 1362(d)(3); (2) the Secretary determines that the circumstances resulting in the termination were inadvertent; (3) no later than a reasonable period of time after discovery of the circumstances resulting in the termination, steps were taken so that the corporation is a small business corporation; and (4) the corporation and each person who was a shareholder in the corporation at any time during the period specified pursuant to this subsection, agrees to make such adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to such period, then, notwithstanding the circumstances resulting in the termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

Conclusion

Based solely on the representations made and the information submitted, we conclude that the rental income X received is passive investment income under § 1362(d)(3)(C). Accordingly, X's S election terminated on D3, because X had subchapter C earnings and profits at the close of each of three consecutive tax years, beginning in Y2, and had gross receipts for each of those years of which more than 25 percent was passive investment income.

We further conclude that the termination of X's S election was an inadvertent termination within the meaning of § 1362(f). Pursuant to the provisions of § 1362(f), X will be treated as continuing to be an S corporation on and after D3, unless X's S election is otherwise terminated under § 1362(d), provided that the following conditions are met. Within 60 days of this letter, X shall file an amended tax return for the Y5 taxable year, electing pursuant to § 1.1368-1(f)(3) to make a deemed dividend distribution of \$a. X must send a payment of \$b with a copy of this letter to the following

address: Internal Revenue Service, Cincinnati Service Center, M/S 343G, Cincinnati, OH 45999. Also within 60 days, X's shareholders must amend their respective Y5 tax return(s) to reflect the changes made to X's Y5 tax return and remit any additional tax due. X's shareholders are responsible for any interest which accrued because of the additional tax due stemming from the amended returns. If these conditions are not met, then this ruling is null and void. Furthermore, if these conditions are not met, X must send notification that its S election has terminated to the service center with which X's S election was filed.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of this transaction or item discussed or referenced in this letter. Specifically, no opinion is expressed concerning whether X's S corporation was valid under § 1362.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,

David R. Haglund
Senior Technician Reviewer, Branch 1
Office of Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures

A copy of this letter

A copy for § 6110 purposes